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DEPRECIATION FREQUENTLY INCORRECTLY DESCRIBED

ONE of the most controversial problems with which an appraiser is confronted is depreciation. It is an intriguing subject and one on which much has been written and said. All experienced appraisers have a working knowledge of depreciation and most of them are able to reach a fairly sound conclusion as to the amount of it that has taken place. Unfortunately, this conclusion is frequently arrived at through "long years of experience and sound judgment." We do not mean to belittle these two staunch pillars. No appraiser can do a thorough job without them. But it seems to us that certain members of the profession are too much inclined to take refuge - in their experience and judgment. Therefore, what should be two stalwart supports of an appraiser's opinion often becomes mere crutches to carry him beyond a position he feels may be indefensible.

We believe that all appraisers, and especially the young ones, can help themselves by attempting to estimate depreciation in an orderly manner. The subject is in itself one of confusion, and confused thinking can only make it more so. It is much easier for a client to understand and accept the appraiser's opinion regarding the amount of depreciation that has occurred, if this opinion is accompanied by logical, straightforward reasoning. Similarly, court testimony presented in this manner is also more convincing.

There are several perfectly acceptable ways in which depreciation may be classified and subdivided. Because most of these methods differ chiefly in terminology, it makes little difference which is used. The important thing is to point out the different types of depreciation and to explain them to the client.

We do not claim that our way of handling depreciation is necessarily the only way. As a matter of fact, we are in the process of making minor changes in our techniques and terminology. But the following outline gives what we consider to be the fundamental types of depreciation.

I - Physical deterioration

A. First under this heading comes *normal wear and tear*. This is the deterioration that takes place gradually throughout the life of the building. It is generally estimated at between 1% and 2% per year, depending on the type and quality of the building. Actually on most types of buildings normal wear and tear will not run this high. In fact, in a well-constructed and well-maintained building, normal wear and tear will amount to less than 1/2 of 1 per cent per year. For example, consider a reinforced concrete and steel building. There is relatively little depreciation due to normal wear and tear at any time in the building's life. This type of building may

become hopelessly obsolete, or its neighborhood or use may change completely, thereby bringing about more rapid depreciation. But to ascribe more than a very small percentage of this depreciation to normal wear and tear is, in our opinion, entirely misleading. This same hypothesis also holds true on less substantially constructed buildings, and the appraiser should treat this type of depreciation logically and carefully and not make it a "catch-all" for other types.

B. *Excessive deterioration for age* is a term that we use to describe abnormal deterioration. Here, we will admit, is a controversial point. It is certainly not always easy to separate "excessive" from "normal" deterioration by definition. About the only way "excessive deterioration for age" can be determined is by comparing the subject property with similar buildings of approximately the same age. If poor materials or poor workmanship or some other condition has caused a building to deteriorate faster than it should have, this fact should be noted in the appraisal report. It should not simply be classified as "normal wear and tear."

C. A *structural fault* is also physical deterioration but it can hardly be called "normal wear and tear" or "excessive deterioration for age." By "structural fault" we mean such defects as cracked foundations, excessive dampness either in the basement or living space, damage caused by settling of the building's foundations, etc. One way of estimating this type of depreciation is to find the cost of correcting the fault. Frequently, however, it is found that this cost is far in excess of the actual loss in market value attributable to the defect. From a practical viewpoint the loss in value due to a structural fault is the difference between what the property will sell for without it and what it will sell for with it. If this line of reasoning is followed, the depreciation due to a structural fault cannot be measured until the appraisal is made and, therefore, may appear to be the result of a rather arbitrary afterthought. Regardless of appearances, it seems to us that no other practical way exists for measuring this type of depreciation, as an estimate based on the cost of correcting the fault might, in some cases, exceed the cost of a completely new building.

II - Functional obsolescence

A. Possibly the most frequently encountered functional obsolescence in residential property is *obsolete building*. This term does not necessarily refer to obsolescence due to the advanced age of the building because a new building can become obsolete overnight, or even in the blueprint stage. By obsolete building we mean that type of functional obsolescence inherent in the building itself. This type of obsolescence may be apparent from the appearance of the building or from the arrangement of its rooms, or from the size or number of its rooms. A residence with small, poorly arranged rooms and inadequate closet or storage space is an obsolete building. There are instances of superadequacy of space and residences in this category are generally depreciated because of "excess capacity."

We are not attempting to write a handbook of depreciation terminology in this bulletin, nor do we feel that the definitions we have given are ironclad. As a matter of fact, it is rather difficult to clearly define all types of depreciation without having some types overlap. It is sometimes virtually impossible to decide whether a certain characteristic of a building should be depreciated because it constitutes "excess capacity" or whether to call it "obsolete building." The distinction is really not important so long as it is classified as one or the other, and not tossed off as "normal

wear and tear" or depreciated for some other totally irrelevant reason. An appraisal report does not have to be meticulous to the last detail in order to avoid being sloppy.

B. *Obsolete equipment* is often, but not always, found in obsolete building. Old-style knob and tube wiring, exposed plumbing lines, hand-fired gravity warm air heating systems and oversized elaborate plumbing fixtures are several examples of obsolete equipment. Obsolete elevators are also frequently found in office buildings and older apartment buildings. The day is rapidly approaching when a good deal of the earliest air conditioning and refrigerating equipment must be considered obsolete.

C. *Excess capacity* is nearly always the companion of an obsolete building. Unnecessarily high ceilings, massive walls, and elaborate and excessive trim are all familiar examples of excess capacity. This type of obsolescence is found in virtually all types of real estate. The mansion of the 1890's with its tremendously high ceilings, spacious halls, ornate woodwork and marble trim is a familiar example of excess capacity. Many architects of older office buildings were guilty of the same "over-design" error. Palatial lobbies with towering ceilings and elaborately inefficient lighting fixtures and miles of corridors lined with marble wainscoting are two common hallmarks of the excess capacity found in office buildings and in some of the so-called luxury apartment buildings.

D. The classic example of a *misplaced improvement* has been used so many times that it scarcely needs mentioning. We refer to the legendary multistory building in the middle of the Sahara Desert. In assigning certain values to depreciation resulting from misplaced improvements (either over- or underimproved), the appraiser should be careful to deal with functional obsolescence only. He should not confuse this type of depreciation with that brought about by economic causes. If the building site has been developed to its highest and best use, there is no loss due to misplaced improvements. If it has not, there is a loss resulting either from overimprovement or underimprovement of the site, and more often than not this loss is due to overimprovement. This type of depreciation should not be confused with economic depreciation (which will be discussed later). A misplaced improvement involves a miscalculation or error in judgment in site development. It does not include loss in value resulting from changing economic conditions or trends.

E. Possibly the most difficult depreciation to explain to an owner, particularly a home owner, is that loss in value resulting from *unsalable features.* This type of depreciation is frequently encountered. A fountain in the dining room, a costly system of electric eye door openers, an elaborate inter-room communication system, in some instances indoor planting areas, are all examples of features that are usually unsalable. They are of great value to the original owner but carry forward very little of that value to the prospective purchaser. We have even heard of an owner who was so impressed with a small brook that ran through his property that he built his house so that the brook would meander through the middle of the living room.

Special-use properties usually possess quite a number of unsalable features, but for the most part they are not so whimsical as those we have mentioned. A church building, for example, is of little value except when used as originally intended. There are instances where church buildings have been converted to other uses,

but this is not often possible. The same is true to almost the same extent in the case of schools, libraries and other institutional buildings.

It is certainly logical to ask whether loss due to "unsalable features" can be applied to all types of appraisals. Where no sale is involved or contemplated it would seem highly improper to depreciate the property on the grounds that certain portions or characteristics of it are "unsalable." In an appraisal to determine market value, this type of depreciation must be applied, but when appraising for purposes where market value is not the prime consideration (appraising for insurable value, for sound value to a going concern, etc.) it should not be applied.

III - Economic depreciation

A. *Inaccessibility* is usually the result of those unfortunate unforeseen changes that take place and over which the property owner has little or no control. A street is widened, or a transit line changed, or the traffic pattern is altered in some other way. Perhaps the city or community changes its direction of growth. Inaccessibility is largely a matter of inconvenience. Therefore, a location is said to be inaccessible when it becomes inconvenient for people to reach. The aforementioned changes in traffic and transportation patterns result in inaccessibility to certain locations and accessibility to others. In fact, insofar as retail locations are concerned, any change that alters the buying and shopping habits of the people who patronize a certain retail center will result in a change in the accessibility of that center. Consider a shopping center that is built up around a large chain department store. If this store moves away, it will take many of the center's customers with it unless it is replaced by a store with similar drawing power. If not, the other stores in the center will lose a good portion of their accessibility. Inaccessibility of retail locations, therefore, results from changes affecting the customer's ability or incentive to visit them.

To a somewhat less extent these same principles apply to residential property. In residential property, however, the degree of inaccessibility depreciation varies widely with the type of property. A country estate located twenty miles from the nearest shopping or business center might be depreciated very little or none at all for inaccessibility. But put a five-room bungalow or a multifamily apartment in the same spot and you will see it lose value rapidly.

B. It is apparently very difficult for some appraisers to depreciate a piece of property because it is *incongruous with surrounding properties and uses.* Most often these incongruities are the result of slow transitions that occur within a district. Zoning changes may allow the encroachment of undesirable uses or economic changes may bring about infiltration of families with lower standard of living. There are few neighborhoods that are static for long periods of time. They reach their point of highest desirability and usually begin to decline. If the quality or desirability of all properties in a neighborhood declines at the same rate, there can obviously be no depreciation attributable to incongruities. However, such is seldom the case. There are usually a small number of properties which for one reason or another receive better care and maintenance than do those surrounding them. Although these properties do not depreciate so rapidly from physical deterioration as do those surrounding them, they "absorb" some of the undesirability of the poorer properties and must be depreciated accordingly. The amount of this depreciation will vary with the proximity of the poorer properties and their degree of undesirability.